

CITY OF SOUTH BEND
Pacific County, Washington
January 1, 1991 Through December 31, 1992

Schedule Of Findings

1. Public Funds Were Misappropriated And Accounting Records Were Falsified And Destroyed

Our audit of the financial records of the City of South Bend revealed that at least \$90,264.60 in public funds was misappropriated by one or more city employees during the period September 1, 1986, through June 30, 1993. There were no federal funds involved in this case. The schedule below summarizes these losses:

| <u>Description of loss</u> | <u>Amount</u> |
|---------------------------------------|---------------------------|
| Unrecorded Cash Receipt Transactions: | |
| Utility Revenue | \$44,736.78 |
| General City Revenue: | |
| Interlocal Government Agreements: | |
| Facilities Security Services | 21,600.00 |
| Property Tax Levy Reduction | 15,837.00 |
| Investment Interest | <u>8,090.82</u> |
| Total General City Revenue | <u>45,527.82</u> |
| Total Amount of Losses | <u><u>\$90,264.60</u></u> |

These funds were misappropriated as described below:

a. Utility Revenue

Entire batches of utility accounts receivable payment transactions were not recorded in the city's cash receipting system. During the period January 1, 1991, through April 30, 1993, funds representing 28 batches of utility accounts receivable payment transactions were not receipted by the clerk-treasurer or deposited intact in the city's bank account. The amount of loss from this method was \$44,736.78.

The utility clerk was primarily responsible for processing all utility revenue transactions. Customer payments were first recorded on a cash register; however, all cash register proof tapes were routinely destroyed. As a result, no one was able to establish the amount or composition of funds actually received at the city. The utility clerk then entered all customer payment transactions on the city's computer accounts receivable records. These funds were subsequently

transmitted to the clerk-treasurer; but, these transfers were not documented with written receipts. Therefore, no one was able to fix individual responsibility for these funds.

When we discussed these irregularities with the utility clerk, she was unable to provide any further explanation for the missing funds.

b. General City Revenue

Accounting records were manipulated to misappropriate public funds by using a check for cash substitution scheme. Payments from a variety of sources, some of which are identified below, were received at the city. However, the clerk-treasurer did not establish accountability for these revenue transactions in the city's cash receipting system. When checks from these sources were deposited in the bank as a part of the city's deposit of cash receipts, a corresponding amount of cash was stolen. The amount of loss from this method was \$45,527.82. Our audit detected the following sources of missing revenue at the city:

(1) Interlocal Government Agreement) Facility Security Services

Under this agreement, Pacific County compensated the city for fire protection, traffic control, parking control, and police patrol services rendered on their behalf. During the period April 23, 1990, through April 26, 1993, the county paid the city \$21,600 for these services.

(2) Interlocal Government Agreement - Property Tax Levy Reduction

Under this agreement, Pacific County compensated the city for reducing its property tax levy. During the period January 1, 1991, through December 31, 1992, the county paid the city \$15,837 for these taxes.

None of the above county payments were ever recorded as revenue in the city's cash receipting system; however, the checks from these transactions were included in the city's bank deposits during the period indicated.

The clerk-treasurer was solely responsible for preparing the city's bank deposits. During our analysis of the city's banking transactions during November and December 1992, we found that the clerk-treasurer included one of these county checks for \$8,513 in the city's November 16, 1992, bank deposit. This check was never recorded as revenue in the city's cash receipting system.

When we initially discussed this irregular transaction with the clerk-treasurer, she readily acknowledged that the transaction actually represented a loss of funds to the city. Since she was primarily responsible for these funds, she also volunteered to make restitution to the city for this loss amount. However, when we subsequently discussed the extent of the city's cash receipt losses with the clerk-treasurer, she revised her response to these irregular conditions. While she acknowledged responsibility for making the city's bank deposits, she could not provide any further explanation for the missing funds.

(3) Investment Interest

The city invested \$15,800 in a ten-year bank certificate of deposit for the Farm Home Administration Reserve Fund on June 6, 1986. The bank paid interest on this investment to the city by cashiers check each quarter. With the exception of the interest payment for the quarter ending September 30, 1993, none of these transactions were ever recorded as revenue in the city's cash receipting system. The total amount of interest from this investment, which was not recorded by the city, was \$8,090.82.

During our analysis of the city's banking transactions during November and December 1992, we found that the clerk-treasurer included one of these bank interest checks for \$288.96 in the city's December 7, 1992, bank deposit. This check was never recorded as revenue in the city's cash receipting system.

When we discussed these irregular transactions with the clerk-treasurer, she stated that the bank interest payment for the quarter ending September 30, 1993, was the first such payment she had ever seen on this investment. While she was able to find the city's copy of this investment certificate during our interview, this investment had been omitted from the city's annual report Schedule of Investment Activity for the past eight years. The clerk-treasurer could not provide any further explanation for the missing interest payments from this investment.

RCW 42.20.070 states:

Every public officer, and every other person receiving money on behalf or for or on account of the people of the state or of any department of the state government or of any bureau or fund created by law in which the people are directly or indirectly interested, or for or on account of any county, city, town or any school, diking, drainage, or irrigation district who:

- (1) Shall appropriate to his own use or the use of any person not entitled thereto, without authority of law, any money so received by him as such officer or otherwise; or
- (2) Shall knowingly keep any false account, or make any false entry or erasure in any account, of or relating to any money so received by him; or
- (3) Shall fraudulently alter, falsify, conceal, destroy or obliterate any such account; or
- (4) Shall willfully omit or refuse to pay over to the state, its officer or agent authorized by law to receive the same, or to such county, city, town or to the proper officer or authority empowered to demand and receive the same, any money received by him as such officer when it is a duty imposed upon him by law to pay over and account for the same, shall be punished by imprisonment in the state penitentiary for not more than fifteen years.

The following internal control weaknesses allowed these misappropriations to occur and not be detected in a timely manner.

- a. There was an inadequate segregation of key duties. In addition, there was no periodic review of the work performed by these individuals by other city management officials who were independent of these functions.
 - (1) The utility clerk/deputy clerk-treasurer was primarily responsible for receiving city revenue. This included funds from transactions which were received both through the mail and over-the-counter. This individual also balanced the cash register at the end of the day, distributed cash and checks received, and recorded utility revenue and adjustment postings in the city's computer accounts receivable records.
 - (2) The clerk-treasurer was solely responsible for preparing the city's bank deposits, issuing treasurer's receipts, making disbursements, making monthly bank reconciliations, and preparing the city's annual financial statements.
- b. There were no procedures to ensure that accountability for all city revenue was properly accounted for and controlled. The city did not prepare a report summarizing the accounting activity for each operating day. Utility revenue recorded by the deputy clerk-treasurer was not agreed to the accountability established on the cash register or to the treasurer's receipts subsequently issued by the clerk-treasurer. Funds transmitted to the clerk-treasurer by the deputy clerk-treasurer were not receipted to fix responsibility for all funds at the city.
- c. All cash register proof tapes were prematurely destroyed. As a result, no one was able to establish the amount or composition of the funds actually received at the city.
- d. Deposits were not always made intact daily.
- e. Utility transactions were not always promptly recorded in the city's computer accounts receivable records.
- f. The city did not adequately prepare or monitor its annual budget. As a result, there was no mechanism in place to control all revenue sources which were available to the city or to monitor any revenue shortfalls which indicated problems needing attention by city managers.

We recommend the city seek recovery of the misappropriated \$90,264.60 and the related audit/investigation costs from their insurance bonding companies. We further recommend the Washington State Office of the Attorney General and the Pacific County Prosecuting Attorney review this matter and take whatever action is deemed necessary under the circumstances. Any compromise or settlement of this claim must be approved in writing by the Attorney General and State Auditor as directed by RCW 43.09.260.

Bond coverage for the city employees is as follows:

Hartford Insurance Company
Blanket Employee Dishonesty Bond
Policy No. 52 PEBHZ6013
\$250,000
January 1, 1989, to September 1, 1993

Arthur Strand Insurance
Employee Bond: Clerk-Treasurer and Municipal Court Judge
Policy No. 525069574
\$100,000
March 27, 1986, to February 1, 1989

Arthur Strand Insurance
Faithful Performance Blanket Bond
Policy No. 52PEBZE1171
\$50,000
March 27, 1986, to February 1, 1989

We also recommend the city:

- a. Review the overall accounting controls, correct the weaknesses outlined above, and implement an effective system of internal controls designed to ensure the protection of city assets.
- b. Retain all accounting records in accordance with the city's records retention plan.
- c. Notify the insurance bonding companies of this claim.

2. The City Should Maintain Positive Cash Balances In All Funds

Our audit disclosed deficit (negative) cash balances at year end for the following city funds:

| <u>Fund Description</u> | <u>1991</u> | <u>1992</u> |
|---------------------------|----------------|----------------|
| Equipment Fund | \$(20,488.59) | \$(76,072.33) |
| Waterfront Revitalization | N/A | (49,379.37) |
| Water Sewer Fund | (14,264.40) | (30,610.33) |
| Garbage | (8,561.97) | N/A |
| FHA Fund | (3,499.02) | (2,207.27) |
| Wastewater Fund | (118,045.31) | (118,045.31) |

Since deficit cash balances represent unauthorized interfund loans, insolvent funds are benefiting from the financial resources of other funds of the city.

RCW 43.09.210 states in part:

. . . All services rendered by . . . one department, public improvement, undertaking, institution or public service industry to another, shall be paid for at its true full value . . . and no department . . . shall benefit in any financial manner whatever by an appropriation or fund made for the support of another.

The above conditions occurred for the following reasons:

- a. Budgets adopted by the city are not "balanced." The city limits their appropriations to expenditures and do not consider "beginning fund balances" or "ending fund balances." Resources do not match the appropriations.
- b. Cash and cash requirements are not monitored or controlled by management.

By not considering the beginning and ending fund balances, expenditures appropriated have exceeded the resources available to pay for them and deficit cash balances result.

The *Budgeting, Accounting And Reporting System (BARS)* manual, Part 2, Chapter 1, for cities, as prescribed by the Office of State Auditor, describes the structure of the budget as follows:

The annual appropriated budget was traditionally used to determine a government's property tax levy, and a ceiling on expenditures was made absolute so that the expenditures of the government unit would not exceed its revenues. This budget was also historically a "balanced" budget, estimated revenues equalling appropriations.

We recommend that the city comply with Washington State law and take appropriate measures to eliminate deficit cash balances.

We further recommend that the city adopt a balanced budget which would limit its

appropriations to its available resources.

3. The City Should Comply With Its Bond Covenants

As a result of the city not monitoring the debt service requirements, the city is not in compliance with their bond covenants.

City Ordinance 964 states:

The city hereby covenants and agrees to maintain the System in good condition, to operate the same in an efficient manner and at a reasonable cost, to establish, maintain and collect such rates for water service and sanitary sewage disposal service furnished as will provide sufficient revenues to produce the gross revenues required to pay the expense of maintenance and operation of the System and the debt service requirements of the Outstanding Prior Lien Bonds as defined in the Bond Ordinance, and to meet the obligations of the City, and otherwise perform all of the covenants of the City as set forth herein and in the Bond Ordinance.

The prior lien, 1963 Bond Ordinance No. 849 states:

Net income of the water/sewer system shall be equal to at least 1.35 times the average annual amount required thereafter to pay the principal and interest on the Outstanding Parity Bonds and the Bonds outstanding.

The following schedule shows the calculation for debt service compliance:

| | <u>1991</u> | <u>1992</u> |
|-------------------------|-------------------|-------------------|
| Revenues: | | |
| Charge for services | \$241,738 | \$249,197 |
| Miscellaneous | <u>2,382</u> | <u>5,256</u> |
| Total Revenues | 244,120 | 254,453 |
| Expenditures, Operating | <u>204,754</u> | <u>219,596</u> |
| Operating Income | 39,366 | 34,857 |
| Required Net Income | <u>65,267</u> | <u>63,846</u> |
| Short of Requirement | <u>\$(25,901)</u> | <u>\$(28,989)</u> |

We recommend that the city monitor the financial requirements to ensure meeting its bond covenant requirements.

4. Annual Reports Should Be Prepared And Submitted In A Timely Manner

Background: This is a continued finding from the last audit report covering fiscal years 1987, 1988, 1989, and 1990.

The City of South Bend's annual financial reports for 1991 and 1992 was not submitted to the Office of State Auditor until July 1993.

RCW 43.09.230 states in part:

The state auditor shall require from every taxing district and other political subdivisions financial reports covering the full period of each fiscal year, in accordance with the forms and methods prescribed by the state auditor, which shall be uniform for all accounts of the same class.

Such reports shall be prepared, certified and filed with the division within one hundred fifty days after the close of each fiscal year . . .

The late preparation of the annual financial reports causes the city's financial data to be unavailable to city management, state government, lenders, and citizens.

We attribute the untimely filing of the financial statements to the city assigning a low priority to this task.

We recommend the city prepare the annual financial report in a timely manner.